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No. 89-255

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1989

REPRINTED COPY

UNITED STATES OF AMERICA, PETITIONER

v.

ENERGY RESOURCES CO., INC.

UNITED STATES OF AMERICA, PETITIONER

v.

NEWPORT OFFSHORE, LTD.

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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1. In our petition (at 13-15), we explain that the decision below directly conflicts with the decisions of three other courts of appeals – *In re Ribs-R-Us, Inc.*, 828 F.2d 199 (3d Cir. 1987); *DuCharmes & Co.* v. *Michigan*, 852 F.2d 194 (6th Cir. 1988); and *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797 (9th Cir. 1987). The existence of this conflict was expressly acknowledged by the court below (see Pet. App. 4a). Respondents' effort to minimize this conflict (Br. in Opp. 2-4) is unpersuasive.

Respondents acknowledge (Br. in Opp. 3) that the rule adopted by the court below is "at odds with the Third Circuit"; they characterize the decision below as establishing a "discretionary test," in contrast to the "*per se* rule" applied by the other circuits. Respondents argue that this is not a "direct" conflict in result because, they assert, it is not clear that the First Circuit, in applying its "discretionary test" to the facts of the cases decided by the Third, Sixth, and Ninth Circuits, would reach a result different from those reached by those courts. This latter assertion is highly questionable but, in any event, it is quite irrelevant. There can be no doubt that the Third, Sixth, and Ninth Circuits, in applying their "*per se* rule" to the facts of this case, would have held that the IRS was not bound by the requested designation provision that was held by the First Circuit to be binding. This is because the different rules applied by the courts are irreconcilable—three courts of appeals have held that bankruptcy courts cannot allow a corporate debtor in a Chapter 11 proceeding to designate priority tax payments for application first to trust fund liability, but the court below has held that bankruptcy courts do have the power to allow such a designation and upheld effectuation of the designations in these cases. Accordingly, the decision below conflicts both in reasoning and result with the decisions of other circuits. This direct conflict in the courts of appeals on a recurring issue of considerable administrative importance warrants review by this Court.

2. Respondents contend (Br. in Opp. 4-7) that the issue in this case "is not of practical importance to the administration of the bankruptcy or tax laws" (*id.* at 4). In particular, they argue that the IRS's ability to collect its trust fund taxes will not be significantly affected by designation provisions because those provisions will not operate to shield responsible persons from Section 6672 liability. Respondents suggest that the IRS can protect itself against any revenue loss

by taking immediate steps to collect directly from the responsible persons. They also argue that, because Chapter 11 reorganization plans are not confirmed unless they are found to be "feasible" (11 U.S.C. 1129(a)(11)), there is little likelihood that the IRS will not receive full payment of its taxes under the plan.

a. Respondents' assertion that the designation provision will not operate to shield the corporation's responsible persons from Section 6672 liability is plainly wrong. The only purpose of the designation provision is to provide such a shield; if the designation provision were as ineffectual as respondents suggest, the corporate debtor would not pursue it. The corporate debtor itself gains nothing from a designation provision. The plan of reorganization must provide for the payment of all priority taxes, and the corporation is unaffected by the manner in which the payments are applied. Conversely, the responsible persons (who are responsible for the creation of the trust fund tax liability because they willfully failed to pay over the trust fund taxes to the government) directly benefit from the provision. Even if the reorganization fails, their separate Section 6672 liability will be reduced to the extent that the corporate debtor's tax payments have been applied to the trust fund liability, thereby reducing the Treasury's ultimate recovery of the delinquent taxes. Thus, the purpose of the designation provision is to relieve the responsible persons of their Section 6672 liabilities.

The government cannot protect itself against this threat to the revenue by taking immediate steps to collect the liability from the responsible persons. Even if the tax liability could be collected quickly from those persons before the designation provision came into play, which is highly questionable,* that collection would not render the designa-

* The assessment of Section 6672 liability against a responsible person does not necessarily lead to rapid collection of the liability. The

tion provision ineffective. A responsible person has two years to seek a refund of amounts collected from him. 26 U.S.C. 6511(a). See *USLIFE Title Ins. Co.* v. *Harbison*, 784 F.2d 1238, 1243 n.6 (5th Cir. 1986). Until the final adjudication of a refund suit or until the expiration of the time for filing a claim for refund, it is not certain that the government will be able to retain any payment made by a responsible person. See *id.* at 1244; *Gens* v. *United States*, 615 F.2d 1335, 1340 (Ct. Cl. 1980). For this reason, the Internal Revenue Manual provides that an assessment against a corporation for trust fund taxes will not be abated upon the satisfaction of the trust fund liability by a responsible person; rather, the assessment is abated upon the expiration of the statutory period for bringing a refund claim. See [2 Administration] Internal Revenue Manual (CCH) para. 5638.1(6), at 6821 (Mar. 1989). Until that time, the designation provision would continue in force and would require the IRS to apply the corporate debtor's tax payments to the unabated trust fund liability. See *United States* v. *A & B Heating & Air Conditioning, Inc.*, 861 F.2d 1538, 1539-1540 (1988), further opinion, 878 F.2d 1311 (11th Cir. 1989). Because IRS policy does not permit collection of more than 100% of the trust fund liability (*USLIFE Title Ins. Co.* v. *Harbison*, 784 F.2d at 1243), the amount of the corporate debtor's payments applied to the trust fund liability would

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responsible person may litigate his liability in a refund suit by paying only a small portion of the claimed liability—an amount equal to the taxes owed for one employee for one calendar quarter—and then filing a claim for refund. See Treas. Reg. § 301.7101-1. He may stay collection of the remaining amount of the liability by posting a bond and complying with the other requirements of Section 6672(b). Thus, regardless of how quickly the IRS proceeds against a responsible person, he can delay the collection of most of his liability, and thereby facilitate the reduction of that liability by the payment of the corporate debtor's taxes in accordance with the designation provision.

form the basis for a refund claim by the responsible person (see *United States* v. *A & B Heating & Air Conditioning, Inc.*, 861 F.2d at 1540).

In sum, the initial collection of the trust fund liability from the responsible persons will not defeat the operation of the designation provision or its ultimate consequence of reducing the responsible persons' Section 6672 liability at the expense of the government's collection of the corporation's total tax delinquency. Only where the corporate debtor makes either *no* tax payments or *all* tax payments under the reorganization plan can the designation provision fail to injure the United States' ability to collect the delinquent taxes.

b. There is similarly no merit to respondents' suggestion that designation provisions are rendered unimportant by the requirement that a reorganization plan be "feasible" before it is confirmed. This requirement does not mean that there is little risk that a confirmed plan will fail. Congress clearly recognized that confirmation does not guarantee a successful reorganization. The Bankruptcy Code explicitly provides for conversion of a reorganization proceeding into a liquidating proceeding upon the debtor's failure to effectuate substantial consummation of the plan or upon any other material default under the plan. 11 U.S.C. 1112(b)(7) and (8). Thus, the mere fact that a reorganization plan must be confirmed does not suggest that a designation provision does not pose a serious risk of loss to the Treasury. Indeed, if it were otherwise, respondents would have no reason to insist on the designation—if all of the corporate debtor's taxes are paid as promised in the plan, nothing will remain to be collected from the responsible persons even if the IRS applies the payments as it sees fit.

For the foregoing reasons, and those stated in the petition, the petition for writs of certiorari should be granted.

Respectfully submitted.

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